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May 22, 2006

David M. Eichenlaub
Division of Economics and Finance
State Corporation Commission
1300 East Main Street
Richmond, VA 23219

Re: Comments Concerning the Status of Competition -- Compliance by the State Corporation Commission with § 56-596.B of the Code of Virginia

Dear Mr. Eichenlaub:

Thank you for your letter of April 7, 2006, requesting comments regarding the status of competition in Virginia pursuant to Virginia Code § 56-596.B.[1] We respond on behalf of the Virginia Committee for Fair Utility Rates and the Old Dominion Committee for Fair Utility Rates (collectively, "the Committees"), which consist of large industrial customers of Dominion Virginia Power ("Virginia Power") and Appalachian Power Company ("Appalachian Power"), respectively.

I. Report Card

In response to prior years' requests of the Commission Staff for comments on the status of competition, the Committees have observed that retail competition for generation services has failed to develop in Virginia. With the exception of a miniscule number of customers purchasing at prices above "capped rates" from a competitive service provider that had stopped offering the service to new customers, there was no retail competition at all.

In terms of the existence of retail competition, little, if anything, has changed; electric competition still has failed to develop in Virginia. Restructuring in Virginia has fallen below expectations in other respects as well, as demonstrated by the attached Report Card on Electric

[1] Section 56-596.B of Virginia's Electric Utility Restructuring Act ("Restructuring Act"), Va. Code § 56-596.B, requires the Commission to recommend actions to be taken by the General Assembly, the Commission, electric utilities, suppliers, generators, distributors and regional transmission entities that the Commission considers to be in the public interest, including actions regarding the supply and demand balance for generation services, new and existing generation capacity, transmission constraints, market power, suppliers licensed and operating in the Commonwealth, and the shared or joint use of generation sites.

Utility Restructuring, which evaluates progress on key issues related to competition and restructuring. It reveals low or failing grades on the degree of retail competition and prospects for future customer savings from competition, customer rates during the transition to competition, the assessment of stranded costs and benefits (i.e., whether power plants are worth more or less than book value), and the entry of independent power producers. We are unaware of reliability problems, so we have given transmission and distribution reliability our only "A" grade. The only "B" grade is utility earnings. Functioning of a regional transmission entity earned a "C" grade after Virginia Power and Appalachian Power finally joined the PJM Interconnection LLC, four years after the original statutory deadline.

II. Committees' Concerns with Electric Restructuring

Electric restructuring in Virginia, raises serious concerns, which can be summarized as follows:

- Customers of both Virginia Power and Appalachian Power will soon face significant, unwarranted rate increases based on an unfair, lopsided process.

- Commencing after 2010, when so-called "capped rates" end, customers of both utilities may face *extraordinary* rate increases, of perhaps 100% or more, that would unfairly enrich both utilities with no corresponding benefit to consumers. After 2010, customers of both utilities are scheduled to pay "market prices" for electricity supply. States north of Virginia, and, indeed, portions of Virginia itself now are grappling with crushing rate burdens resulting from going to "market" prices for electric supplies.

We discuss these concerns in greater detail below. In connection with the near term increases, we first discuss those related to Virginia Power and then those related to Appalachian Power. The concerns regarding near-term increases arise primarily from fundamentally unfair provisions in the Restructuring Act that (i) prohibit the Commission from initiating base rate decreases even if utilities' costs and revenues would warrant such decreases, and (ii) require the Commission to grant rate increases but ignore utilities' costs and revenues that would mitigate or eliminate the need for such increases. We discuss these concerns below in connection with both Virginia Power's and Appalachian's near term rate increases. We also discuss below the exorbitant future rate increases that may result from imposition of market prices on customers of both utilities upon the expiration of "capped rates."

A. Virginia Power's Near Term Rate Increase

Virginia Power's current "base" (or non-fuel) rates were established in a rate case decided by the Commission in 1998. The Restructuring Act, enacted on July 1, 1999, essentially "froze" those base rates.

The Restructuring Act permits utilities to recover certain "stranded costs" through their rates. With customers given the opportunity to choose a supplier other than their local utility, it was claimed at the time of enactment that utilities might be unable to recover costs incurred under the pre-existing regulatory regime.

The Commission Staff's most recent review of Virginia Power's level of profits and rates shows that Virginia Power accumulated more than $1.2 billion "available for stranded cost" recovery from 1998 through 2003.[2] Only a miniscule number of Virginia Power's customers, however, have elected to obtain service from a supplier other than Virginia Power. Thus, while it has not experienced its first dollar of "stranded cost," Virginia Power accumulated more than a billion dollars toward "stranded cost" recovery as of the time of completion of the most recent Commission Staff review of its finances. Further, the same Commission Staff report shows that Virginia Power's base, or non-fuel, rates are excessive by about $400 million per year, or about 10% of total rates.[3]

While Virginia Power accumulated such significant amounts for what turned out to be non-existent "stranded costs," its fuel factor rose steadily. From 1998 through 2003, Virginia Power's fuel factor increased from 1.152 cents/kWh to 1.613 cents/kWh.[4] Because charges imposed by Virginia Power through its fuel factor account for a disproportionately large portion of the total bill of its large industrial customers, significant increases in the fuel factor adversely affected large industrial customers. (Virginia Power's current fuel factor accounts for approximately 40% of the total bills of its large industrial customers.)

In December 2003, the Commission issued an order establishing a new fuel factor of 1.891 cents/kWh for Virginia Power to take effect on January 1, 2004. A few months later, in the 2004 Session, the General Assembly amended the fuel factor provisions of the Virginia Code, among other things, by freezing that fuel factor through June 30, 2007. The General

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[2] The Commission Staff reviews annual financial data filed by Virginia Power and other electric utilities. The Staff completed its most recent report concerning Virginia Power's financial data on October 15, 2005. That report covers data for the year 2003.

[3] Virginia Power has filed its Annual Informational Filings for 2004 and 2005; however, the Commission Staff has not yet completed its review of those filings.

[4] Virginia Power's fuel factor was 1.050 cents/kWh from May 1998 to December 1998; 1.152 cents/kWh from December 1998 through January 2000; 1.339 cents/kWh from February 2000 through December 2000; and 1.613 cents/kWh from January 1, 2001 through December 31, 2003.

Assembly's amendment further required that, prior to that date, the Commission would establish another fuel factor tariff to take effect on July 1, 2007 and remain in effect through December 31, 2010. (The 2004 amendment to the fuel factor provisions of the Code prohibited the Commission from increasing Virginia Power's fuel factor to permit collection of fuel costs not recovered through the current fuel factor or decreasing the fuel factor to credit customers for any over-recovery of fuel costs through the current fuel factor. In the 2006 Session, the General Assembly adopted an amendment to the fuel factor provisions of the Virginia Code that requires the Commission to set annual fuel factors, commencing July 1, 2007, and requires such fuel factors to be 'trued up' for under- or over- recoveries incurred by Virginia Power subsequent to that date. Thus, the fuel factor that takes effect on July 1, 2007, will remain in effect for one year and be subject to adjustment, starting July 1, 2008, for under- or over-recovery of fuel costs from July 1, 2007.)

Since 2004, Virginia Power's fuel costs have risen substantially, and its current fuel factor has not produced sufficient revenues to recover such costs. However, the over-recovery of its non-fuel costs in its base rates, discussed above, will likely offset the under-recovery of its fuel costs.

Virginia Power's customers now face a potentially *significant* fuel rate increase on July 1, 2007. Because projected fuel costs are higher than the level of such costs included in the calculation of its current fuel factor, Virginia Power may request an increase in its fuel factor of as much as 50% or more, which could increase customers' bills by as much as 20% or more. While the 2006 amendment to the fuel factor provisions of the Code, § 56-249.6, permit the Commission to defer for later recovery up to 40% of such increase, thereby smoothing the effect of any rate "shock" that otherwise might occur on that date, deferral of the recovery of such costs in the fuel factor merely means paying them later.

Any such increase in fuel costs, moreover, cannot, under current law, be offset by a corresponding decrease in Virginia Power's non-fuel, or base, rates because the Restructuring Act essentially freezes its base rates. Thus, even though its base rates remain essentially frozen by law at an excessive level (according to the Commission Staff's most recent analysis), Virginia Power may be able to increase its fuel factor significantly and continue to collect deferred amounts through 2010. It can continue to enjoy the benefit of the excess revenues collected through its base rates while also increasing its fuel factor to collect increases in its fuel costs. Large industrial customers, whose bills are significantly affected by changes in the fuel factor, will be especially disadvantaged. Their fuel factor may increase significantly with no offsetting decrease in base rates.

In sum, Virginia Power's customers, including its large industrial customers, face a potentially significant, unnecessary, and unwarranted rate increase on July 1, 2007.

B. Appalachian Power's Near Term Rate Increases

Appalachian Power's current base rates were established in a rate case decided in 1999. Since that time, Appalachian's base rates have not produced excess revenues to the extent of those produced by Virginia Power's base rates. In fact, the Commission Staff's most recent report on Appalachian Power's level of profits and rates, dated April 27, 2005, shows that, based on 2004 data, Appalachian's current rates under-collect its costs by more than $49 million per year. (This contrasts with the Commission Staff's report for the prior year, 2003, which found a revenue excess of $9.7 million per year.)

The Restructuring Act prohibits the Commission, whether on its own initiative or in response to a complaint by customers or any customer representatives, such as the Division of Consumer Counsel of the Attorney General's Office, from reducing Appalachian's base rates, so the Commission was not able, as a result of the findings in the Staff's report for 2003, to initiate a proceeding to determine whether Appalachian's rates should be reduced. This prohibition contrasts with the provision in the Restructuring Act permitting the Commission to "adjust" Appalachian's "capped rates" to reflect changes in the cost of fuel. Pursuant to that provision, the Commission recently increased Appalachian's fuel factor by 3.65 mills/kWh, effective January 1, 2006. This increase in the fuel factor resulted in an increase in the bills of Appalachian's large industrial customers of more than 10%; however, due to the prohibition in the Act against Commission-initiated base rate changes, the Commission could not even consider changes in Appalachian's base rates that might have been warranted and that might have had the effect of offsetting the fuel factor increase.

The prohibition against Commission-initiated base rate changes also contrasts with the requirement for the Commission to "adjust" Appalachian's base rates for certain specified categories of costs *known to be increasing*, regardless of whether all of its other costs and revenues warrant any change in rates. One of the 2004 amendments to the Restructuring Act *requires* the Commission to "adjust" Appalachian's so-called "capped rates" not more frequently than once every 12 months for incremental environmental compliance and transmission and distribution reliability costs ("E&R" costs) prudently incurred on and after July 1, 2004. Thus, pursuant to the Restructuring Act, the Commission must "adjust" Appalachian's "base," or non-fuel, rates, for E&R costs, which are known to be increasing, but the Commission is prohibited from considering all of Appalachian's non-fuel costs and revenues and modifying Appalachian's rates accordingly. On July 1, 2005, Appalachian Power filed an application with the Commission to increase its "capped rates" for E&R costs. As modified by Appalachian during the case, the application seeks an average annual increase of 3.06%. The request is currently pending before the Commission.

Moreover, unlike the provisions in the Restructuring Act applicable to Virginia Power, the Act's provisions relating to Appalachian permit it to seek, prior to July 1, 2007, a change in its base rates based on a traditional rate case in which all of its costs and revenues are considered.

Appalachian recently has filed with the Commission an application for an average annual increase of about 25%. Thus, due to the prohibition against Commission-initiated rate changes, the Commission has not been able to order any rate reduction that otherwise might have resulted from excess base rates, but now Appalachian's customers may face a significant base rate *increase*, instituted by Appalachian, and any such increase may be over and above both the recent (and any future) fuel rate increases and any annual E&R base rate increases resulting from currently pending, and subsequent, E&R rate cases.

In sum, the Restructuring Act causes unfair and unreasonable rates that disadvantage Appalachian's customers. The Act prohibits the Commission from initiating a case to reduce Appalachian's rates when they produce excess revenues, but it has permitted rate increases. Appalachian has increased its fuel factor, and now it is poised to increase its base rates, both in its recently filed general rate case and in its pending and future "E&R" cases.

C. Future Exorbitant Rate Increases from Market Prices for Customers of Virginia Power and Appalachian Power

Beyond the Committees' concerns about the unfair and lopsided law that permits selective rate increases (but not rate decreases) for Virginia Power and Appalachian Power, the Committees are deeply concerned about the prospect of extraordinarily large rate increases resulting from market-based pricing after expiration of the current, "capped rates."

Pursuant to the Restructuring Act, "capped rates" are scheduled to expire on December 31, 2010. Rates for generation and related services will be based on the Commission's determination of market prices after that date. While no one can predict with certainty prevailing market prices for such services at that time, the current difference between market prices and the "capped rates" of Virginia Power and Appalachian Power suggests that going to market-based prices could be devastating for consumers, including large industrial consumers. Presently, large industrial customers of Virginia Power pay about 4.5 cents/kWh, on average, while large industrial customers of Appalachian pay about 3.5 cents/kWh. In contrast, market prices in the PJM region have caused utilities' retail rates to customers in Maryland and Delaware, where capped rates have ended, or are about to end, to exceed 10¢/kWh. This would represent an increase of 100% to almost 200% in bills to some industrial customers of Virginia's two largest utilities.

Moreover, as the Commission's most recent annual report to the Commission on Electric Utility Restructuring ("Restructuring Commission") has emphasized, the poorly functioning wholesale market -- which, after December 31, 2010, would drive prices for Virginia Power's and Appalachian's retail customers – does not bode well for customers of those utilities. Trends and features in the wholesale market, as stated in that report, include the following:

- the so-called "single price auction" (where the price in wholesale spot market is set by the offer price of the last unit required to meet load, not by the average cost of power from a diverse fleet of generating resources, as is the case under cost of service regulation by the Commission);

- an increasing tendency toward oligopoly as a result of mergers in the power generation sector;

- new capacity pricing constructs, or relaxed market mitigation, which may result in additional cash flow to the generation sector; and

- challenges related to market monitoring and related concerns about the exercise of market power.

In sum, the expiration of so-called "capped rates" in 2011 could result in massive rate increases for customers of Virginia Power and Appalachian Power, and in related adverse impacts on Virginia's homes, businesses and economic development, as compared to other states, such as North Carolina, which have not restructured their electric industry.

The Restructuring Commission is, of course, launching a two-year study of the impact of the expiration of the "capped rates," but it need look no farther than to states north of Virginia to glimpse the future. Here are only a couple examples:

- In Maryland, in the face of the ending of capped rates and being forced to market prices, Alcoa shut down an aluminum smelter with 600 jobs lost. That state's largest utility, Baltimore Gas and Electric ("BG&E"), will go to market rates in July. The Maryland Public Service Commission, which has estimated that a typical residential customer would be hit with rate increases of 72%, has proposed to "phase in" the rate increase, thus reducing the impact of the increase in July. Participants in the "phase-in" plan, however, still would be required to pay BG&E the entire amount of the increase that is deferred for later payment. Merely "phasing in" massive rate increases mitigates their immediate impact but, because customers ultimately must pay the massive, deferred costs, obviously does not represent a solution to the increase itself.

- In Delaware, Delmarva Power announced in February that it would raise its residential rates by approximately 59% on May 1, when rate caps expired in that state. Delmarva Power's rates for large commercial and industrial customers were to increase even more. The General Assembly enacted a "phase-in" plan to help customers defer, but not avoid, the rate increases unless customers elected to "opt-out" of the plan, in which case they would pay the entire increase commencing May 1.

Beyond such current experiences in nearby states, the Restructuring Commission need not look beyond Virginia's own borders to appreciate the impact of going to market prices. Delmarva has filed an application with the Commission seeking an average rate increase of 50% in its Virginia territory (as much as 65.3% for certain large commercial and industrial customers) as a result of going to market-based rates, and the Commission's annual report to the Restructuring Commission, cited above, describes the "rate shock" of customers of some Virginia electric utilities (Craig Botetourt Electric Cooperative, City of Danville Municipal, City of Bristol Municipal) resulting from large price increases necessitated by exposure to current and expected future wholesale market conditions.

Conclusion

We hope you will take the Committees' concerns into account as you continue to study and assess public policy in this area, and we appreciate the opportunity to share those concerns with you. In formulating the Commission's findings regarding the status of competition, and in developing recommendations to the General Assembly, the Committees urge the Commission to consider these comments. Electric restructuring has not worked so far in Virginia, and recent developments do not bode well for its future success.

Sincerely,

Louis R. Monacell

Edward L. Petrini

REPORT CARD
VIRGINIA ELECTRIC RESTRUCTURING

ISSUE	GRADE	COMMENT
Degree of retail competition	F	Retail competition has produced no customer savings. A significant portion of Virginia's retail customers has had the legal right to choose since January 1, 2002. With the exception of a few "green" power sales at prices higher than the utility's capped rates, no supplier has offered to serve retail customers.
Prospects for future savings from retail choice	F	Present market prices and trends suggest that retail customers of Appalachian Power Company ("APCo") and Dominion Virginia Power ("DVP") have few or no prospects for savings from retail competition in view of the fact that market prices now greatly exceed the regulated generation costs of APCo and DVP.
Customers rates during the transition to competition	D	The State Corporation Commission ("SCC") Staff's most recent report on DVP's earnings and indicates that its rates are excessive by 10% and would be reduced by approximately $400 million per year if reset based on cost of service. DVP's rates have soared since the Act passed in 1999 due to rate "adjustments" to reflect increased fuel costs. Legislation enacted in 2004 froze DVP's 2004 fuel factor through June 2007. As a result, customers now are paying a lower fuel factor than otherwise would have been the case. DVP's fuel factor is likely to rise again significantly on July 1, 2007, when the SCC re-sets it. The SCC, however, still cannot offset the increase by considering DVP's base (non-fuel) rates. The SCC most recent report on APCo's earnings indicates an annual "revenue deficiency" of about 5.2%. This month, APCo applied to the SCC for a general base rate increase. It stated that the increase, if granted, would increase rates approximately $198 million, or about 25% on average. Based on SCC Staff's most recent financial review and the rate application, it appears that APCo's rates are collecting revenues below its costs. The 2004 amendments to the Act, on the other hand, encourage unfair, single-issue rate increases for APCo without permitting the SCC to review the total cost of service to determine whether cost reductions or revenue increases would offset such increases.

Utility earnings	B	DVP's annual report to the SCC for 2003 states that DVP earned a jurisdictional return of 13.26% on common equity. The SCC Staff has not completed its review of DVP's 2004 or 2005 annual informational filings ("AIFs"); however, the 13.26% rate of return exceeds the 9.10% to 10.10% rate of return found reasonable in the SCC Staff's review of DVP's 2003 annual report, the most recent AIF reviewed by the SCC Staff. While APCo's Virginia electric business appears to have produced modest over-earnings during 2003, APCo's earnings -- as indicated in the recent SCC Staff report on its 2004 AIF and in APCo's most recent general base rate increase application, discussed above -- appear to be falling below a reasonable range.
Assessment of stranded costs and stranded benefits (whether power plants are worth more or less than book value)	F	The Virginia Electric Utility Restructuring Act ("Act") requires an assessment of whether utilities have over- or under-collected "stranded costs" (*i.e.*, costs rendered unrecoverable as a result of restructuring and competition). Despite the likelihood that no stranded costs exist, no such determination has been made.
Functioning of Regional Transmission Entity (RTE)	C	The Act initially required utilities to join an RTE by January 1, 2001. Neither DVP nor APCo met the statutory deadline. In 2003, two years after the deadline, the General Assembly eliminated the original deadline and enacted a *new* deadline that requires utilities to join an RTE by January 1, 2005, subject to approval by the SCC. Both utilities have now joined the PJM Interconnection, LLC.
Entry of independent power producers	D	Generation owned or controlled by DVP and APCo continues to dominate Virginia's generation market. Independent power producers have built little new generation since passage of the Act. In fact, DVP has added to its generation fleet more MWs than the independents. As a result, market power has not been eliminated and possibly has been enhanced.

Reliability of distribution and transmission system	A	Capped rates could motivate Virginia utilities to decrease expenditures on reliability in order to increase profits and thereby reduce reliability. The SCC, in reviewing utilities' responses to Hurricane Isabel, stated that it appeared that DVP had decreased the number of linemen it employs but that "the Staff has not observed a deterioration in day-to-day operations based on standard measures of performance." Nevertheless, the Staff determined that it was appropriate to conduct an "in-depth audit" of DVP's resources beginning in the fourth quarter of 2004 as a result of "(i) anecdotal feedback from customers and anonymous employees relative to a decline in resources, (ii) the natural incentive to reduce resources within a rate cap environment, and (iii) the belief that any deleterious effects of a reduction in resources might not materialize until years later …" The SCC staff's audit was completed and no serious deficiencies were shown. We are not aware of an independent, in-depth review of transmission and distribution reliability. In the absence of such a review, we must assume that normal measures of performance are being met. We remain cautious, nevertheless, about the effect of restructuring on transmission and distribution reliability in view of the factors cited by the SCC Staff as well as the significant reductions in employees reported by DVP to the SCC Staff during its post-Isabel audit. Employees in the "transmission" category declined by 61%, for example, during the period 2000 through 2004, while employees in the "distribution" category declined 23.34%.